IN THE

Supreme Court of the United States

OCTOBER TERM, 1961.

No. 719

In the matter of

GLOSTEN PRODUCTS, INC.,

Bankrupt

—v—

S. HARVEY KLEIN, Trustee of the Bankrupt,

Petitioner,

vs.

IRVING HERMAN,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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INDEX

	PAGE
Petition for Writ of Certiorari	1.
Opinion of the Court Below	1, 2
Jurisdiction of This Court	2
Questions Presented for Review	2
Statement of the Case	4
Reasons for Granting the Writ	7
Argument	
The import of the decisions of the District Court and Court of Appeals is that a court-appointed officer of a Debtor in Possession may consciously and deliberately disobey, with impunity, a statute and an order of the Bankruptcy Court requiring segregation and payment of withholding taxes; that although such officer occupies a fiduciary position, he may conceal his continuing violations from the Court, the creditors of the Debtor, and his own lawyer during a three month period, and then secure court approval of such actions on the ground that they did not constitute willful breaches of his fiduciary duty.	7
The District Court and Court of Appeals were in error when they predicated their decisions upon the authority of this Court's opinion in Maggio vs. Zeitz, 333 U.S. 56, 68 S. Ct. 401, 92 L. Ed. 476. In the instant cause the respondent was in a fiduciary capacity as the only active executive of a Debtor in Possession operating under the provisions of Chapter XI of the Bankruptcy Act. The rule enunciated in Maggio vs. Zeitz DOES NOT apply to one in a fiduciary capacity, and this Court has so held	8

PAGE

The decision of the United States Court of Appeals for the Seventh Circuit in this case is in conflict with decisions of the United States Court of Appeals for the Third Circuit and this Court 8

Conclusion 20

Table of Citations.

Cases.

Bloom v. United States, 272 F. 2d 215 12

In re Cheney Bros., 12 F. Supp. 605, 608 ..... 13, 17

In re Haynes, 88 F. Supp. 379 12

Hercules Service Parts Corp. v. United States, 202 F. 2d 938, 940, 941 13

In re James Butler Grocery Co., 12 F. Supp. 851, 852 ..... 13, 17

Levy v. United States, 140 F. Supp. 834 12

Maggio v. Zeitz, 333 U.S. 56 ..... 4, 8, 9, 15, 16

May v. Henderson, 268 U.S. 111 ..... 17, 19

Mosser v. Darrow, 341 U.S. 267 13

Nugent v. United States, 135 F. Supp. 875 12

Paddock v. Siemoneit, 147 Tex. 571, 218 S.W. 2d 428, 7 A.L.R. 2d 1062 12

In re Philadelphia & Western Ry. Co., 64 F. Supp. 738, 740 ..... 13, 17

Rabinovitz v. Oughton, 92 F. 2d 297 ..... 17, 19

Stanton v. Machiz, 183 F. Supp. 719 12

United States v. Illinois Central Ry. Co., 303 U.S. 239 12

Urban Properties Corporation v. Benson, 166 F. 2d 321, 324 ..... 13, 17

PAGE

In re Walker, 83 F. 2d 281 ..... 13, 17

Wiggins v. United States, 188 F. Supp. 374 12

In re Wil-Low Cafeterias, Inc., 111 F. 2d 83, 84 ..... 13, 17

STATUTE.

Internal Revenue Code, 1954, 26 U.S.C.A. Sec. 6672 11

TEXTBOOK.

Collier on Bankruptcy, 14th Ed., Vol. 2, Sec. 23.10, p. 539, note 24 18

Collier on Bankruptcy, 14th Ed., Vol. 8, Sec. 6.32, pp. 802, 803 13

MISCELLANEOUS.

Lawyers' Edition Annotation to Maggio v. Zeitz, 92 L. Ed. 508 18

Revenue Ruling 54-158, 1951-1, Cum. Bull. 247 12

APPENDICES.

Appendix A.

Opinion and Judgment of the Court of Appeals for the Seventh Circuit 1a

Appendix B.

Orders of Court of Appeals affirming order of District Court and denying petition for rehearing 6a, 7a

Appendix C.

Excerpts from cross-examination of respondent at hearing before Referee in Bankruptcy 8a

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GLOSTEX PRODUCTS, INC.,

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S. HARVEY KLEIN, Trustee of the bankrupt,

Petitioner,

vs.

IRVING HERMAN,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner, the trustee of the Estate of Glostex Products, Inc., bankrupt, prays that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Seventh Circuit in the above entitled proceeding.

OPINIONS OF THE COURTS BELOW.

The opinion of the Court of Appeals for the Seventh Circuit is reported in 295 F.2d 324 (Advance, December

11, 1961), and is printed as Appendix "A" hereto. The opinion of the United States District Court is reported in 190 F. Supp. 538.

JURISDICTION OF THIS COURT.

The judgment of the Court of Appeals for the Seventh Circuit is dated and was entered October 18, 1961. A Petition for Rehearing was denied November 16, 1961. The petitioner believes 28 U.S.C. Sec. 1254 (1), 62 Stat. 928, confers jurisdiction on this Court to review the judgment in question by Writ of Certiorari.

QUESTIONS PRESENTED FOR REVIEW.

I.

Whether the Referee in Bankruptcy erred in surcharging a court appointed chief executive officer of a Debtor in Possession who withheld taxes from employees' wages, but deliberately and consciously failed to pay such taxes to the government in violation of an order of the Bankruptcy Court.[1]

II.

Whether a District Court sitting in Bankruptcy and exercising jurisdiction over the operations of a Debtor in Possession has jurisdiction to approve the application of money withheld from employees' salary checks for taxes to anything but the payment of those taxes.

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[1] There is no question of exoneration from the obligation of the withholding tax statute by the court order continuing the Debtor in Possession; a supplement to the order specifically directed the withholding and segregation of the taxes.

III.

Whether the District Court and the Circuit Court of Appeals were correct in deciding that a corporate officer charged with conducting the operations of a Debtor in Possession, though a fiduciary, must be forgiven for a conscious and deliberate diversion of tax funds, if the funds were not demonstrated to be in his possession when the diversion was called to the Court's attention.

IV.

Whether in the exercise of their general supervisory and reviewing power over the Referee in Bankruptcy, the District Court and Circuit Court of Appeals properly decided that the Referee was mistaken in holding to account the chief executive officer of the Debtor for the following acts of that officer extending over a three month period while he was in complete control of the Debtor in Possession operating under the jurisdiction of the Bankruptcy Court:

(a) Deliberate and conscious violations of a court order requiring the weekly segregation and deposit of withholding taxes on salaries of the Debtor's employees;

(b) Concurrently paying his own weekly salary;

(c) Daily paying the Debtor's suppliers who refused to deliver merchandise other than on a C.O.D. basis;

(d) Paying rent to his brother, the lessor of the premises occupied by the Debtor corporation;

(e) Permitting a finance company daily to loot and rifle the mail of the Debtor; but,

(f) During the same three months period not once revealing to his own lawyer, the presiding Referee in

bankruptcy, or a single creditor that the aforedescribed events were transpiring.

V.

Does the rule of *Maggio* v. *Zeitz*, 333 U.S. 56, 68 S. Ct. 401, 92 L. Ed. 476, the sole authority upon which the District Court and Court of Appeals based their decisions, apply to a case in which a fiduciary is involved.

STATEMENT OF THE CASE.

Glostex Products, Inc. was a Chicago corporation engaged in manufacturing and distributing automobile seat covers. Irving Herman (the respondent) was president of the company. With its affairs worsening, Glostex filed on April 22, 1957 a petition for an Arrangement under the provisions of Chapter XI of the Bankruptcy Act (App. 4). An order was entered granting the petition, continuing the Debtor in possession of its properties, and authorizing Herman, as president, to operate its business (App. 8).

One of the Debtor's creditors was the United States.[2] Consequently, the United States District Attorney immediately took steps to protect the Revenue. On the same day as the order was entered authorizing the Arrangement proceedings, the District Attorney procured the entry of a supplemental order from the District Court explicitly detailing that in the future operation of its business, the Debtor would be required to segregate and hold apart from its other funds all moneys withheld from employees' salary checks for taxes, or what is commonly known as withholding taxes, deposit them in a separate bank account, and to remit such funds from time to time to the appropriate authority as required by law (App. 9, 10).

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[2] Glostex owed corporate taxes of $51,388.17 (App. 11, 12). It was not yet diverting withholding tax funds.

Had respondent complied with that order, this proceeding would never have arisen. The case is here simply because Herman deliberately failed and refused to obey the Court's directive. He used for other purposes the money he withheld from employees' salaries and which should have been remitted to the Treasury to pay the employees' income taxes.

For the last three months of the Debtor's operations (January, February and March, 1958) no withholding taxes were deposited in the designated depository, although net wages and salaries were paid, as were the Debtor's suppliers who would not deliver except on a C.O.D. basis, and the landlord of the Debtor's premises (respondent's brother) was paid his rent (App. 59, 60, 69).

When, after a year of operating under the jurisdiction of the Bankruptcy Court in the Chapter XI proceeding, the Debtor was adjudicated a bankrupt, petitioner was appointed Trustee in Bankruptcy and initiated proceedings to enforce personal liability against Herman for the tax funds he had diverted.

At the hearings before the Referee, Herman laid the blame on National Acceptance Corporation, a finance company authorized by order of court to advance funds to the Debtor in the conduct of its business, for his failure to pay the withholding taxes (App. 51-43). He contended that the finance company refused to allow him to allocate any funds for the purpose of paying the withholding taxes, and that because of such refusal he was powerless to do otherwise (App. 51, 52).

However, on cross examination (excerpts from which are printed as Appendix "C" hereto) Herman was frank to admit that from the very inception of the Chapter XI proceedings he was aware not only of the statutory obligation imposed upon him and the Debtor to pay the with-

holding and social security taxes (App. 56, 57), but that he was also conscious of the fact that the court had entered an order specifically requiring the Debtor to make weekly segregation of funds sufficient to make such payments (App. 56, 57); (Appendix "C", p. 8a). For example, respondent acknowledged that despite the fact that approximately $32,000 was paid by the Debtor in January, 1958 for the purchase of material from suppliers who would deliver only on a C.O.D. basis, he made no allocation of funds or payment of withholding and social security taxes for the same month (App. 59, 60); (Appendix "C", pp. 8a, 9a).

Although contending that he orally requested the Finance Company to release funds for tax payments during the months involved, respondent admitted he made no written requests. He confessed that he never actually drew a check to pay the withholding taxes which the Finance Company declined to approve (App. 63); (Appendix "C", p. 9a).

He conceded that the Finance Company never forbade him to make withholding tax payments (App. 67, 68); (Appendix "C", p. 10a).

He acknowledged he never informed the Bankruptcy Court of the actions of the Finance Company, and admitted that for the three months period involved he concealed from the Bankruptcy Court, his own attorney, and the creditors, his violation of the court's order relative to payment of the withholding taxes (App. 65, 66); (Appendix "C", pp. 9a, 10a, 11a).

After hearings, the Referee entered an order in which he found that while respondent was the president and operating head of the Debtor, he consciously, deliberately and without justification failed to segregate or pay withholding taxes on employees' salaries for the peri-

od of January, February, and March, 1958, which failure and omission constituted a deliberate violation of the Internal Revenue Code and the supplementary order entered in the proceeding on April 22, 1957. The Referee further found that none of the provisions of the supplemental order were ever changed or modified; and that respondent never advised the court, the attorney for the Debtor, or any of the creditors of his continuing failure and omission to make such payments or deposits. Based upon the foregoing findings, respondent was directed to pay the estate or the Director of Internal Revenue the sum of $9,634.18 or such greater or lesser sums as might be found necessary to satisfy the claim for withholding taxes for the period of January, February and March, 1958 (App. 76-78).

On appeal the District Court and Circuit Court of Appeals determined that the trustee's action to enforce personal liability against Herman was in the nature of a "turn-over" proceeding. Not finding the tax moneys in the hands of Herman personally, the courts said he had nothing to turn over and excused him entirely from any liability for diverting the tax funds.

REASONS FOR GRANTING THE WRIT

1. The import of the decisions of the District Court and Court of Appeals is that a court-appointed officer of a Debtor in Possession may consciously and deliberately disobey, with impunity, a statute and an order of the Bankruptcy Court requiring segregation and payment of withholding taxes; that although such officer occupies a fiduciary position, he may conceal his continuing violations from the Court, the creditors of the Debtor, and his own lawyer during a three month period, and then secure court

approval of such actions on the ground that they did not constitute *willful* breaches of his fiduciary duty.

2. The District Court and Court of Appeals were in error when they predicated their decisions upon the authority of this Court's opinion in *Maggio* v. *Zeitz*, 333 U.S. 56, 68 S.Ct. 401, 92 L.Ed. 476. In the instant cause the respondent was in a fiduciary capacity as the only active executive of a Debtor in Possession operating under the provisions of Chapter XI of the Bankruptcy Act. The rule enunciated in *Maggio* v. *Zeitz*, **does not** apply to one in a fiduciary capacity, and this Court has so held.

3. The decision of the United States Court of Appeals for the Seventh Circuit in this case is in conflict with decisions of the United States Court of Appeals for the Third Circuit and this Court.

ARGUMENT.

1.

The Court of Appeals and the District Court in the instant case have held that a bankruptcy court is powerless to supervise the acts of its own appointee, the president of a Debtor in Possession in a Chapter XI proceeding, who by his own admission repeatedly violated an order of the court which appointed him. Those violations occurred weekly during a three month period, *were admittedly deliberate and conscious*, and hidden from the court (App. 56, 65); (Appendix "C" pp. 9a, 11a). Respondent used tax moneys withheld from salaries of the Debtor's employees for such purposes as he saw fit, in specific violation of the Internal Revenue Code and a court order. When apprehended, he blamed a finance company for his inability to comply with the court order and failure to carry out his duties. Because he did not personally pocket the tax monies, and because the bankruptcy trustee did not prove respondent had possession of the specific funds in question (indeed, no attempt was made to prove such possession) the Court of Appeals, on the authority of *Maggio* v. *Zeitz*, 333 U.S. 56, 68 S. Ct. 401, 92 L. Ed. 476, declined to surcharge respondent's account and, as it were, gave him a pat on the back, deciding that his violations of a statute, disobedience to a court order, and concealment of his offenses, did not amount to a "willful breach of any fiduciary duty".

This is a wholly new and pernicious doctrine. First of all, it completely ignores the fact that respondent frankly *admitted* his violations of the court order and statute were conscious and deliberate and not the result of inadvertence,

negligence, or bad advice (Appendix "C" pp. 8a, 11a, 12a). Consequently, the holding of the Court of Appeals that there was no "willful breach of any fiduciary duty" by respondent is completely contradicted by the record. Secondly the opinion impliedly seeks to equate the concept of "willfulness" with "evil design", or "wrongful intent". The law is otherwise. When respondent chose to use the withheld tax moneys for other purposes—to pay suppliers, his own salary and rent—he made the choice consciously and deliberately (Appendix "C" pp. 8a, 9a, 11a). As a result, he acted "willfully".

The entry of the supplemental order of April 22, 1957 (App. 9, 10), procured by the District Attorney, was merely a judicial affirmation of respondent's statutory obligation to account for and pay to the government the taxes he withheld from employees' salaries. The respondent's obligation to obey the statute and remit the tax moneys was the same, with or without the entry of the order.

The Referee found that respondent while "president and operating head of the Debtor in Possession under the former Chapter XI Proceeding herein, consciously, deliberately, and without any justification therefor, for the period of January 1, 1958 through March 31, 1958, failed and omitted to segregate and hold separate and apart all moneys withheld from employees for taxes under the laws of the United States or any state or to deposit such funds in a separate bank account no later than one week subsequent to such collecting or withholding, which failure and omission constituted a deliberate violation of the provisions of Sections 3402 and 7501 of the Internal Revenue Code of 1954, and the Supplement to the order entered herein April 22, 1957 authorizing Glostex Products, Inc. to continue as Debtor in Possession and operate its business, and which required the deposits to be made as aforedescribed." (App. 77).

This finding of the Referee as to the deliberate and conscious nature of respondent's failure to pay the tax moneys was accepted without question by both the District Court and Circuit Court of Appeals.

Implicit in the Court's authority to enter the supplemental order of April 22, 1957 was the power to punish one who consciously and deliberately disobeyed it. Certainly, it was within the Bankruptcy Court's power to surcharge its own trustee for violating an order aimed squarely at that trustee. The Internal Revenue Code similarly provides penalties for those who withhold, but do not pay the taxes on their employees' wages. (26 U.S.C.A. § 6672). That section provides as follows:

> "Sec. 6672. Failure to Collect and Pay over Tax, or Attempt to Evade or Defeat Tax.
>
> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under Section 6653 for any offense to which this section is applicable."

Historically, the question of personal or corporate liability for employees' income taxes withheld at the source dates from the withholding or pay-as-you-go system of tax collection. Once the government put its revenues into the hands of corporate and individual employers for the purpose of collection, it was found necessary to impose sanctions for derelict collectors. This resulted in the enactment of Section 6672 of the 1954 Code.

The novelty of a personal obligation being imposed upon an employer for taxes withheld from an employee's wages

spawned litigation, but the cases have been uniform in holding that when the person charged with the responsibility of collecting an employee's withheld income tax makes a conscious, deliberate, or voluntary election not to pay the withheld tax moneys to the government, then that decision is "willfully" made, and he is personally liable to the government for the unpaid taxes. *Bloom* v. *United States*, 272 F. 2d 215; *In re Haynes*, 88 F. Supp. 379; *Nugent* v. *United States*, 136 F. Supp. 875; *Levy* v. *United States*, 140 F. Supp. 834; *Stanton* v. *Machiz*, 183 F. Supp. 719, 725; *Wiggins* v. *United States*, 188 F. Supp. 374, 376, 377; *Paddock* v. *Siemoneit*, 147 Tex. 571, 218 S.W. 2d 428, 7 A.L.R. 2d 1062; *Rev. Ruling 54-158*, 1951-1 Cum. Bull. 247; see also, *United States* v. *Illinois Central Ry. Co.*, 303 U.S. 239, 58 S. Ct. 533, 535, 82 L. Ed. 773.

In *Bloom* v. *United States*, 272 F. 2d 215 (Cert. Den. 1960, 363 U.S. 803, 80 S. Ct. 1236, 4 L. Ed. 2d 1146), the government, invoking the provisions of 26 U.S.C.A. §6672, brought an action against the president of a corporation for the amount of income and social security taxes withheld from wages of employees of the corporation but not paid over to the Treasury. The trial court entered judgment against defendant for the amount of unpaid taxes. On appeal, defendant made the same contention as respondent did here: that the bank financing the corporation was in control of the corporation's finances, dictated what disbursements should be made, and that it was the bank's decision, not defendant's, not to pay the withholding taxes. From this premise, defendant argued that his failure to pay the taxes was not "willful", and that he should not be chargeable therefor. In affirming the District Court, the Court of Appeals found that based on defendant's own testimony, the corporation had funds in the bank in amounts in excess of the taxes on the due dates thereof, but

that defendant directed such funds to be used for other purposes with full knowledge that the withheld taxes were due and payable. Accordingly, the Court of Appeals determined that the decision of defendant not to pay the government was voluntary, conscious, and intentional, held, therefore, that such conduct was "willful", (272 F. 2d 223), and affirmed the judgment of the trial court.

Respondent, Herman, did not achieve immunity from personal liability as a result of his decision not to pay the withheld taxes when his company became subject to the jurisdiction of the bankruptcy court. If an Arrangement proceeding under Chapter XI of the Bankruptcy Act is to become a tax-free haven available to failing corporations and those persons who operate them, and if an Arrangement is to be employed as a vehicle whereby withheld tax moneys can be used to pay general creditors, accounts receivable financiers, landlords, and others, then this must certainly be regarded as both a disaster to those charged with the collecting of the revenue and a boon to those who welcome every opportunity to find leaks (legal or illegal) in the enormous flow of withheld tax money which should rightfully be paid to the government.

The respondent here occupied a dual capacity. He was a corporate officer (App. 16, 17), and as operating head of a Debtor in Possession, a fiduciary. *Hercules Service Parts Corp.* v. *United States*, 202 F. 2d 938, 940, 941; *Collier on Bankruptcy*, 14th Ed., Vol. 8, Sec. 6.32, pp. 802, 803; *In re Wil-Low Cafeterias, Inc.*, 111 F. 2d, 83, 84; *In re Cheney Bros.*, 12 F. Supp. 605, 608; *In re Walker*, 93 F. 2d 281; *In re James Butler Grocery Co.*, 12 F. Supp. 851, 852; *Urban Properties Corporation* v. *Benson*, 166 F. 2d 321, 324; *In re Philadelphia & Western Ry. Co.*, 64

F. Supp. 738, 740. As a result, the attempt of the Court of Appeals to exonerate him because he did not personally profit from his violations of the court order is in direct conflict with this Court's decision in *Mosser* v. *Darrow*, 341 U.S. 267, 71 S. Ct. 680, 95 L. Ed. 927. In *Mosser*, the Court of Appeals absolved a bankruptcy trustee from any personal liability resulting from his actions in permitting his two key employees to profit from their dealings in certain securities which comprised the corpus of the bankruptcy estate. These actions of the employees were never revealed to the bankruptcy court, nor was an order ever obtained authorizing the trustee to allow them to engage in such transactions. In reversing the Court of Appeals, this Court held the trustee chargeable with the profits realized by his employees despite the fact that the trustee did not personally profit, the bankruptcy estate suffered no loss, and in fact profited from his management of the estate. In the instant case the reliance which the Court of Appeals placed upon the fact that respondent did not personally pocket the money which should have been used to pay withholding taxes is rendered meaningless when read in the light of the *Mosser* case.

Likewise, we submit that there is simply no logic in the Court of Appeals' attempted justification of the respondent's derelictions during the last three months of his office on the ground that he did what he was required and paid to do during the first nine months thereof. Certainly, adequate performance of a fiduciary duty during the first three quarters of a term does not justify repeated violations in office during the final quarter. Only to state the proposition demonstrates how untenable it is.

We realize the seriousness of what we say. However, it is felt that the issue presented is basic to effective ad

ministrations of the bankruptcy laws, to the preservation of the integrity of the bankruptcy courts, and proper collection of the Revenue.

One in charge of a Debtor has the obvious opportunity and advantage to manipulate its affairs to circumvent the payment of taxes. We ask, what purpose will it serve in the future for a United States District Attorney to procure the entry of an order directing segregation and payment of withholding taxes by a Debtor? Obviously, it meant nothing to respondent in this case. If the opinion of the Court of Appeals is allowed to stand it will give aid and comfort to those presently in charge of Debtors in proceedings pending throughout the country who might now be thinking of doing what respondent did here. The finance company was allegedly responsible for respondent's violations here; it was a bank upon whom the blame was attempted to be placed in the *Bloom* case. We suggest that subsequent variations on this theme of blame-shifting will be limited only by the degree of ingenuity possessed by those who in the future find themselves faced with similar charges of diverting withheld tax moneys in the same manner as respondent did here.

2.

The decision of *Maggio* v. *Zeitz*, 333 U.S. 56, 68 S. Ct. 401, 92 L. Ed. 476, the authority upon which the District Court and Court of Appeals predicated their reversal of the referee's order, does not sustain those decisions for two reasons:

First. The sole issue presented and determined by this Court in *Maggio* was whether in a proceeding by a trustee to enforce compliance by the president of the bankrupt with a previously issued turnover order, the respondent may avoid an adjudication of contempt by

alleging and proving that the property or its proceeds sought to be recovered from him has, since the entry of the turnover order, been dissipated and no longer in his control.

This Court answered that issue in the affirmative saying (333 U.S. 56, 69) that a coercive contempt order should not be issued when it appears that there is an incapacity to comply. The decision in *Maggio* envisions two separate and distinct proceedings, (a) the entry of a valid turnover order, and (b) enforcement proceedings initiated by the trustee for non-compliance. The factual situation presented to this Court and decided by it in *Maggio* involved only the second phase, *i.e.*, enforcement of a turnover order previously entered. In the instant cause there were no proceedings instituted against respondent for non-compliance with the Referee's order because he petitioned for review of that order prior to the end of the period specified for compliance. There was no hearing or evidence taken upon respondent's ability or inability to comply with the order, or his current state of solvency or insolvency.

Obviously, then, the instant case is not the type of proceeding reached by the decision in *Maggio*.

Second, the doctrine of *Maggio* v. *Zeitz*, 333 U.S. 56, 68 S. Ct. 401, 92 L. Ed. 476, does not apply to a case involving a fiduciary.

The trustee's contention that respondent occupied the role of a fiduciary during the Chapter XI proceeding was never questioned. The law clearly prescribes that the manager of a Debtor in Possession shall be classified as a fiduciary and charged with the duties and characteristics of a trustee. *Collier on Bankruptcy*, 14th Ed., Vol. 8, Sec. 6.32, pp. 802, 803; *In re Wil-Low Cafeterias, Inc.*,

111 F. 2d 83, 84; *In re Cheney Bros.*, 12 F. Supp. 605, 608; *In re Walker*, 93 F. 2d 281; *In re James Butler Grocery Co.*, 12 F. Supp. 851, 852; *Urban Properties Corporation* v. *Benson*, 166 F. 2d 321, 324; *In re Philadelphia & Western Ry. Co.*, 64 F. Supp. 738, 740.

In *May* v. *Henderson*, 268 U.S. 111, 45 S. Ct. 456, 460, 69 L. Ed. 870, a bankruptcy proceeding, this Court squarely decided that the duty of a fiduciary to account for property entrusted to his care is fulfilled only by delivery of the property, and if he has put it out of his power to deliver, he may nevertheless be compelled to account for its worth.

The *May* case has been followed by the Court of Appeals for the Third Circuit in two cases involving factual situations in bankruptcy proceedings paralleling the instant case: *Reifsnyder* v. *B. Levy & Son*, 88 F. 2d 287, and *Rabinovitz* v. *Oughton*, 92 F. 2d 297. In the latter case, the Court said, 92 F. 2d 299:

> "In the second place, the appellant contends that he did not have possession of the property which he was ordered to turn over, but that he had paid it to other persons.
>
> The referee and the District Court, however, found that he was in possession of the money when the petition in bankruptcy was filed, but, even if he had paid the money to his individual creditors as he asserts, the turnover order could be sustained.
>
> Since the appellant occupied a fiduciary position, he is not relieved of the duty to account for the property merely by placing it beyond his control. 'If he has sold it or mingled it with his own, he may be compelled by summary order to restore the value of the property thus wrongfully diverted.' *May* v. *Henderson*, *supra*, 268 U.S. 111, at page 119, 45 S. Ct. 456, 69 L. Ed. 870.

The reason a turnover order is not usually granted where the bankrupt is not shown to possess or control the specific property is because the order might be futile. But the appellant has not shown that he is insolvent or in other respects unable to comply with the order of the District Court. Therefore, under the facts of this case the order should be affirmed regardless of appellant's allegation, even if true, that he had paid the money to others. *May* v. *Henderson, supra*, 268 U.S. 111, at pages 120, 121; 45 S. Ct. 456, 460; 69 L. Ed. 870.

The order of the District Court is affirmed."

Citing the *May*, *Reifsnyder* and *Rabinovitz* cases as authorities, the annotation to the *Maggio* case in the Lawyer's Edition of this Court's reports states unqualifiedly that the rule of *Maggio* is inapplicable to cases involving fiduciaries, and that in instances where the person proceeded against occupies a position which places him in a fiduciary relationship, lack of present possession or control of property is no answer to a court order directing its return. 92 L. Ed. 508.

In *Collier on Bankruptcy*, Vol. 2, Sec. 23.10, p. 539 (14th Ed.) the authors reiterate the same rule in note 24 to the main text.

We respectfully submit that the doctrine of *Maggio* v. *Zeitz* has been misapprehended in the instant cause. Respondent was nothing if not a fiduciary. There was involved, therefore, a factual situation to which the doctrine of *Maggio* does not apply. But even more fundamental, the issue decided in *Maggio* (relief from contempt proceedings because of inability to respond) never arose in the instant cause.

3.

The decision of the Court of Appeals for the Seventh Circuit that one in charge of a Debtor's management and occupying the role of a fiduciary may not be compelled to respond financially for losses occasioned by his violations of a court order, unless it be first proved that he is possessed of the specific funds in question, is in conflict with this Court's decision in *May* v. *Henderson*, 268 U.S. 111, 45 S. Ct. 456, 69 L. Ed. 870, and decisions of the Court of Appeals for the Third Circuit in *Rabinovitz* v. *Oughton*, 92 F. 2d 297, and *Reifsnyder* v. *B. Levy & Son*, 88 F. 2d 287, cases heretofore cited and discussed under the previous section of our argument.

If the decision of the Court of Appeals in the instant cause is correct, then the salutary rule of law enunciated in the *May*, *Reifsnyder* and *Rabinovitz* cases will have been effectively nullified. We respectfully suggest that the conflict has arisen because the Court of Appeals for the Seventh Circuit chose to excuse a fiduciary's violation of his trust on the basis of a bizarre tale of a knowledgeable businessman caught in the clutches of a finance company, but physically unable to acquaint anyone with his plight. This is pure invention born of necessity, and the foundation for an opinion of the Court of Appeals which could undermine the effective administration of bankruptcy reorganizations and the collection of withheld tax moneys involved in those proceedings. Since the fiscal year ending June 30, 1957, the filings of Chapter XI proceedings have, with one exception, increased yearly. These proceedings form a substantial part of the business of the bankruptcy courts throughout

ten circuits of our Federal judiciary[3], and, as a result, we believe the decision of the Court of Appeals will find more than infrequent application in the daily routine of bankruptcy administration.

CONCLUSION.

It is respectfully submitted that this case presents basic issues involving important questions of bankruptcy law which have been decided contrary to the decisions of this Court, the Court of Appeals for the Third Circuit and recognized bankruptcy authorities. The very integrity of the bankruptcy courts, their ability to deal with their own appointees, and to oversee the revenue which should rightfully be paid to the government is at issue.

For the reasons heretofore set forth, the petitioner respectfully requests that this Court issue a Writ of Certiorari to the Court of Appeals for the Seventh Circuit to review its decision in this case.

Respectfully submitted,

THOMAS D. NASH, JR.
ROBERT M. AHERN
111 West Washington Street
Chicago 2, Illinois
Counsel for Petitioner.

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[3] In the fiscal year ending June 30, 1957, 599 Arrangements were filed; in fiscal 1958, 724 Arrangements were filed; in fiscal 1959, 787 Arrangements were commenced; in fiscal 1960, 622; and in 1961, 947. **Tables of Bankruptcy Statistics, 1957, 1958, 1959, 1960, 1961, Administrative Office of the United States Courts.**

APPENDIX A.

IN THE

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

SEPTEMBER TERM AND SESSION, 1961

No. 13304
In the Matter of GLOSTEX PRODUCTS, INC., Bankrupt.

S. HARVEY KLEIN, Trustee of the bankrupt,
Appellant,
v.
IRVING HERMAN,
Appellee.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

October 18, 1961

Before HASTINGS, *Chief Judge*, KNOCH and KILEY, *Circuit Judges.*

HASTINGS, *Chief Judge.* This bankruptcy proceeding originated on April 22, 1957 when Glostex Products, Inc. filed its petition for an arrangement under Chapter XI of the Bankruptcy Act. On that date an order was entered permitting debtor to continue in possession of its property, and operate its business. On the same date a supplemental order was entered requiring debtor to segregate and deposit in a separate bank account all moneys withheld from employees' wage for taxes.

By order of April 29, 1957 debtor was authorized to borrow money from National Acceptance Company with which to carry on its business. In return National Acceptance Company received a first lien on all assets of debtor, including present or future accounts receivable.

Debtor fully complied with the order concerning taxes withheld from employees' wages through December, 1957. There was no segregation and deposit of these moneys for January, February and March, 1958.

Debtor was adjudicated a bankrupt on April 21, 1958. Irving Herman was the general manager and the only active executive of debtor, Glostex Products, Inc.

After adjudication of bankruptcy, the District Director of Internal Revenue sought an allowance of $9,634.18, representing withholding taxes for the three months when they were not deposited, as a special trust fund for the United States. Although the exact amount of the taxes was in dispute, the propriety of the Director's claim was conceded and is not questioned here. In response to the Director's claim, the trustee sought an order requiring Irving Herman to pay the amount of the claim of the United States for the withholding taxes. At the hearing which followed, the undisputed testimony of Herman disclosed that during the three months when the withholding taxes were not deposited, the financial affairs of debtor were virtually controlled by National Acceptance Company. All disbursements were subject to approval by this finance company. All checks drawn on debtor's account were subject to prior approval by National. In February, National began to open debtor's mail and withdraw all checks. Herman testified that when he requested funds from National with which to pay withholding taxes he was told that it would be taken care of. He admitted that he had never written a check with which to deposit the taxes nor had he been ordered not to do so. Nevertheless, it is apparent that Herman entertained a belief that National would not allow the taxes to be paid.

As a result of the hearing, the referee found that Herman, as operating head of debtor, had deliberately failed

to segregate and deposit the withholding taxes and ordered him to pay to the estate or the Director of Internal Revenue the amount necessary to satisfy the claim of the United States.

On petition for review, the district court construed the referee's order as a turnover order and held that the requisite possession upon which to premise such an order had not been shown. The district court, therefore, vacated the referee's order. It is this decision which is in question here.

The trustee contends that Herman was a fiduciary with respect to the operation of the debtor in possession, that he breached his duty by failing to deposit the withholding taxes, and is thus personally liable for the amount due the United States. Herman contends that the district court was correct in its construction of the referee's order as a turnover order, and that the requisite possession has not been shown.

Initially, then, it must be determined whether the referee's order was a turnover order. In *Maggio* v. *Zeitz*, 333 U.S. 56 (1948), the Court speaks of a turnover order as being a remedy. Whether or not the order in the instant case is a turnover order is to be determined by the nature of the remedy contemplated by the order. The trustee's amended petition prayed for an order directing Herman to pay and, upon default, for a rule upon Herman to show cause why he should not be held in contempt. The referee's order directed Herman to pay the claim of the United States, and the trustee presumably, would have initiated a contempt proceeding had not the district court vacated the order. This is the exact remedy that was before the Court in *Maggio* which involved a contempt proceeding for failure to obey what is conceded to be a turnover order. Furthermore, here the parties considered the proceeding before the referee as a turnover proceeding. In a colloquy between counsel for Herman and the referee, the proceeding is referred to as "turnover." The trustee did not object to such denomination. We hold that the district

court did not err in determining that the proceeding before the referee was a turnover proceeding resulting in a turnover order.

Further, *Maggio* v. *Zeitz, supra,* holds that a person against whom a turnover order has been directed may show in a subsequent contempt proceeding that he is presently unable to comply due to present lack of possession. In the instant case there was no allegation that Herman possessed the money in question nor was there proof that he had such possession. In discussing the history and nature of turnover orders the Court in *Maggio* pointed out that such orders were fashioned by bankruptcy courts to aid in proper administration by summarily retrieving the assets of the estate. Turnover orders are analogized to common law actions for the recovery of possession, and the Court concludes by stating: "It is no sense based on a cause of action for damages for tortious conduct such as embezzlement, misappropriation or improvident dissipation of assets." *Id.* at 63. It follows that a turnover order may not issue without a showing of possession. 2 Collier, Bankruptcy § 23.10, p. 538 (14th ed. 1956).

In its memorandum opinion the district court further found and determined:

> "The debtor [Herman] in the instant case is not accused of withdrawal of funds for his personal use. It is charged he used money for the purchase of merchandise from suppliers when he should have set aside some of the funds for taxes. The record is clear he derived no personal gain and in fact disbursed the money he received. This debtor [Herman] can not be ordered to turn over that which he does not possess.
>
> "The record of this case discloses that from April 1957 through December 1957 the debtor [Herman] fully complied with the order of the Referee on withholding and social security taxes. It further shows that commencing in January the finance company reduced the amount of money being advanced to the debtor [Herman] and that it exercised control over

the manner of its disbursement; hampering the debtor [Herman] in the exercise of his discretion as to the allocation to be made of the moneys so advanced. Considering the entire record, this court is of the opinion that the debtor [Herman] should have brought this situation to the attention of the court earlier, but that this omission was not a deliberate and wilful defiance of the Referee's order."[1]

Our consideration of the record in this proceeding leads us to conclude that the district court did not err in so finding.

Under the circumstances of this case, we hold that there was no wilful breach of any fiduciary duty by Herman.

The order of the district court appealed from is affirmed.

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[1] The record discloses that the order to segregate and hold separate the withholding taxes was entered by the district court, acting through Judge J. S. Perry, on April 22, 1959, and not by the Referee.

APPENDIX B.

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago 10, Illinois

Wednesday, October 18, 1961

Before

Hon. John S. Hastings, Chief Judge

Hon. Wm. G. Knoch, Circuit Judge

Hon. Roger J. Kiley, Circuit Judge

In the Matter of Glostex Products, Inc., Bankrupt. S. HARVEY KLEIN, Trustee of the Bankrupt, Appellant, No. 13304 vs. IRVING HERMAN, Appellee.	Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the order of the said District Court entered therein on January 23, 1961, in this cause appealed from me, and the same is hereby, Affirmed, with costs, in accordance with the opinion of this Court filed this day.

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago 10, Illinois

Thursday, November 16, 1961

Before

Hon. John S. Hastings, Chief Judge.

In the Matter of GLOSTEX PRODUCTS, Bankrupt. S. HARVEY KLEIN, Trustee *Appellant.* v. IRVING HERMAN, *Appellee.*	Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 13304	

It is hereby ordered by the Court that the Petition for a rehearing of this appeal be, and the same is hereby DENIED.

APPENDIX C

(App. 56, 57)

Cross Examination by Mr. Nash.

Q. You told us, Mr. Herman, that you knew at the inception of your position as president of the Company, that the company was required to pay the taxes on employee payroll, did you not?

A. Yes.

Q. And at the inception or the adoption of the special proceeding of April, 1957 until December of 1957, that these withholding Social Security Taxes were to be paid; you knew that?

A. Yes, sir.

Q. And you were conscious of the fact that the Court here entered an order specifically requiring that the Debtor in Possession make those withholding Social Security tax payments?

A. Yes, sir.

• • •

(App. 59, 60)

Q. Now, about how much would you say that you spent in the purchase of merchandise in the month of January, 1958?

A. I wouldn't remember.

Q. Take a look at that.

(Handing document to witness)

A. At that time it shows $26,600.00.

Q. For the month of January?

A. For the month, yes for the month ending—this shows a number of operations from eleven to eleven; this is during the eleven months, this is January.

Q. Was that some—

A. It was some of the operations for November to January.

Q. To January?

A. Well this report it shows the purchase of merchandise, a cash purchase of $17,000.00; I am not positive from this whether the payment is all the merchandise bought; or whether it might be from the prior month.

Q. Approximately $32,000.00. Was the money actually laid out in January for the purchase of supplies or materials?

A. Yes, according to these figures.

Q. That is right, isn't it?

A. That must be correct.

• • •

(App. 63, 64)

Q. Then getting back to my question, is it your testimony that the National Acceptance Corporation either forbid you to or wouldn't approve a check which you desired to draw to pay the withholding Social Security tax?

A. I wouldn't say they would not approve it, sir.

Q. Did they say they would not approve the check?

A. No.

• • •

(App. 65)

Q. Did you know by February 15th that the taxes, the withholding Social Security taxes for January had to be paid, a deposit had to be made?

A. Yes, sir.

Q. And you knew by March 15th that the taxes that had accrued to February had to be paid?

A. Yes, sir.

Q. You knew there was an order of this Court requiring such payment?

A. Yes.

Q. Did you ever present that matter to the Court, the refusal of the National Acceptance Corporation, to allow you to pay monies to the United States Government?

A. I didn't immediately, because I didn't—

Mr. Lansing: Just answer the question.

The Witness: No, I didn't. They promised me—there were no funds, there wasn't any cash, there wasn't any more money; it was necessary to have some funds; we

had waited three or four months and we had hoped they could come across this time. They failed, and I became desperate and as I testified I came into Court.

• • •

(App. 36)

Q. Now I am asking you, before you filed or before you ultimately went into bankruptcy, did you ever come in and ask this Court or tell this Court what was going on at Glostex and that the reason you could not pay was because they were withholding funds to pay the Social Security taxes?

A. No, sir.

• • •

(App. 67, 68)

Q. Well, so we have this straight about these conversations and these requests you made to the people at National Acceptance, there was never any direct order from any of those people to you not to make deposits for withholding Social Security taxes, is that right?

A. I would say the way they operated with me was that they strictly expected me to make out checks only for those dealers which they O. K'd.

Mr. Nash: Mr. Reporter will you read the question.

(Question read)

The Witness: A. No, there was no direct order not to make them.

Q. And you never did draw, actually did draw a check to pay those amounts required, did you?

A. No, I did not.

Q. So that there was never a situation where they refused to pay a check which you drew to satisfy those amounts?

A. Not for those; I had occasion when I did draw checks and they stopped them.

Q. I am talking about the Social Security checks that is all?

A. No, I never made a check, no, but there never were any funds there.

Q. Did you ever draw a check for somebody on the American National Bank when it wasn't paid?

A. No.

• • • •

(App. 74-76)

The Referee: When in the month of January did you get the full 75 per cent realized out of your accounts; the month of January, the first of the year?

The Witness: Your Honor, that amount became curtailed in February; I don't recall as to January;

The Referee: When they came over, the Acceptance Corporation to get your mail, that was in February?

The Witness: That was in February; the early part of February.

The Referee: When did they take possession of your bank accounts and checks that were being sent to you?

The Witness: They didn't have it under entire control but I didn't seem to have anything to say in the sense that apparently the American National Bank answered to their requests.

Mr. Lansing: When did they start to take supervision?

The Witness: In December they were also in touch with the bank because there were checks sent that came in.

The Referee: Didn't you ask the National Acceptance Corporation if these things were permitted to them in the contract?

The Witness: Your Honor, I couldn't refer to the contract; I was under the impression that they had a prior lien on everything and anything in the corporation.

The Referee: That they might have had prior liens, that is an unusual contract that would provide for them going and getting the mail and your bank accounts and you do nothing about it. Anyway what did you do about it; did you talk to anybody about it?

The Witness: We had quite a few discussions about it.

The Referee: Anybody connected with the case?

The Witness: Yes; they gave me the impression they wanted to go along and help us; the suppliers had stated they they wanted to go along with us. Your Honor we had an offer from the creditors to go along with us, but

we didn't have any recourse. We had to go somewhere to get some help; and we tried to formulate an organization plan.

The Referee: What did you do about reducing the percentage on your accounts; did you talk to anybody about it?

The Witness: I didn't talk to anybody specifically.

The Referee: You had four or five meetings with the creditors; did you advise the creditors about it?

The Witness: No, sir.

The Referee: Then what determined you to go and have your business adjudicated a bankrupt?

The Witness: Well it was the same every month, when I saw I wasn't getting any place, the funds were getting less and less; I wasn't able to operate; I had to get funds to pay the taxes and I had to have the necessary dollars so that we operate the business.

The Referee: In any event you didn't notify anybody connected with this matter about the situation until at least two months after.

The Witness: I discussed this matter with the attorney in a general sense and I discussed it that we were trying to get funds and I know that we had many meetings with the National Acceptance Corporation attempting to get relief and that we needed so much funds to operate; this was a matter from week to week and they were constantly saying that "we will go along with you and then it would go until the next week and so on.

The Referee: Didn't it occur to you to appeal to the Court after their failure to comply with their contract to pay you when this had gone on for a few months?

The Witness: It was the last week that I came to the conclusion that I could not go on any more and I did come into Court.